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India ’ s Intergovernmental Transfer System and the Fiscal Condition of the States

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Abstract

India's fiscal deficit and steep deterioration in state finances is a source of concern. The literature abounds with references to the combined fiscal deficit of the center and the states currently at over 10 per cent of GDP. During no other eight year period has the debt-GDP ratio rose by more than 10 percentage points where the ratio of outstanding debt to GDP increased from 21 per cent in 1996-97 to 35 per cent in 2004-05 (Budget Estimate). In this paper, we contend that the lack of State fiscal discipline is due in large part to a flawed intergovernmental fiscal system that fosters fiscal profligacy at the state level. Specifically, the States are highly dependent on transfers from the Union Government, which breaks the Wicksellian link between costs and benefits. There is a lack of transparency and accountability in the system because of extensive use of inadequate revenue assignments, lack of sufficient decentralization to local bodies, and a poorly designed intergovernmental transfer system. Finally, the States are operating under soft budget constraints which encourage fiscal profligacy.

In this paper, we concentrate our discussion on issues related to the intergovernmental fiscal transfer system. We contend that the high transfer dependency of the states has weakened accountability and fiscal discipline. The transfer system is also very complex and lacks transparency and coordination among the institutions in charge of implementing transfers, which together produce a cycle of distorting incentives. If the fiscal behavior of the States reflects the incentives created by the intergovernmental system, as we contend, then, absent structural reform of the intergovernmental fiscal system that addresses the perverse incentives of the current system, the fiscal trends described above are likely to persist. Although the Twelfth Finance Commission (TFC) has addressed some of the issues related to the intergovernmental fiscal system and soft budget constraint, there is still an urgent need to tackle other issues in the intergovernmental fiscal system that create perverse incentives and soften budget constraints. This emphasizes the need for the State and Union Governments of India to strengthen and accelerate the reform of India's intergovernmental system.

Keywords: intergovernmental fiscal system, India, fiscal deficit, state finances, soft budget constraint, transfer system.

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Introduction

Indian State finances are a source of growing concern. According to the Twelfth Finance Commission Report (2004, page 37), "…the six years from 1997-1998 to 2002-2003, have been the worst in the history of state finances." During this period, the ratio of state debt-to-GDP increased from 21 percent to 35 percent. The literature abounds with references to the combined fiscal deficit of the center and the states, currently at over 10 percent of GDP. In addition to the growing debt burdens of the states, the composition of state expenditures is also cause for serious concern. State expenditures on interest, pensions, and wages were approximately 76 percent of the total revenue receipts of the States in fiscal year (FY) 2003-04 (Revised Estimates), and investment in power, irrigation, transportation, and urban infrastructure has stagnated in recent years. This threatens India's ability to sustain robust economic growth.

We contend that the lack of state fiscal discipline is due in large part to a flawed intergovernmental transfer system that fosters fiscal profligacy at the state level. Specifically, the States are highly dependent on transfers from the Union Government, which breaks the Wicksellian link between costs and benefits. The high transfer dependency of the states has weakened accountability and fiscal discipline. The transfer system is very complex and lacks coordination and transparency among the three current institutions in charge of implementing transfers, which together produce a cycle of distorting incentives. The transfer formulae are also complex and lack clearly defined objectives. If the fiscal behavior of the States reflects the incentives created by the intergovernmental transfer system, then, absent a structural reform of the intergovernmental fiscal system that addresses the perverse incentives of the current system, the fiscal trends described above are likely to persist. Although the Twelfth Finance Commission (TFC) has made an attempt to address some of the issues identified in the intergovernmental fiscal system, there is still an urgent need to tackle other issues in the system that create perverse incentives and soften budget constraints This emphasizes the need for the State and Union Governments of India to strengthen and accelerate the reform of India's intergovernmental system.

In this paper, we discuss the problem of aggregate fiscal discipline as it relates to India's intergovernmental fiscal transfer system. We begin by reviewing the fiscal condition of the States of India in section I. Then, in section II, we identify the flaws specifically related to the design of the intergovernmental transfer system and soft budget constraints, and we incorporate the Twelfth Finance Commission's recommendations to tackle these issues. Finally, in section III, we evaluate various options for reform of the transfer system in India and provide a set of recommendations. Section IV contains concluding remarks.

Section I. The Fiscal Condition of State Finances

The State List in the 7th Schedule of the Constitution entrusts the states with major expenditure responsibilities in the areas of human and physical development. However, the tax revenues of the States are not sufficient to meet these expenditure responsibilities. The resulting fiscal imbalances of the states are addressed through a complex system of intergovernmental transfers in various forms and through various channels. Additionally, over the years, the States of India have sought to finance their increasing needs for expenditures through loans, rather than by raising additional tax revenues and/or charging for services delivered. This has led to the States running large revenue and fiscal deficits and accumulating unsustainable debt burdens. In this process, most States have compromised budgetary discipline, resorted to off-budget forms of borrowing, and accumulated large contingent liabilities, with the attendant risks of default (Bahl et al, 2005).

During the ten year period beginning in the mid-1980s, there was a slow but steady deterioration in the revenue deficits of the States. Starting in 1997-98, however, this steady decline turned into a sharp deterioration. As shown in figure I.1, state revenue deficits averaged 0.8 percent of gross domestic product (GDP) between 1987-88 and 1996-97, and 2.8 percent of GDP from 1997-98 to 2000-01. Then, in both 2001-02 and 2002-03, the States made some progress in reducing their revenue deficits. However, the revised estimates for 2003-04 show another sharp deterioration in state fiscal balances. The States are financing these deficits through borrowings. Consequently, the total debt of the States has increased from the already high level of 20.7 percent of GDP in 1987-88 to 35 percent of GDP in 2004-05 (Budget Estimates) (RBI, 2004). Figure I.1 also shows the obvious fact that the growth in state revenue deficits is attributable to the failure of revenue receipts to keep pace with the growth in revenue expenditures. Absent a matching increase in revenue receipts, the fiscal shock represented by the large wage and pension increases by the States in 1997-98 has led the way to large and persistent revenue deficits and growing state debt burdens as a share of GDP.

Figure I.2 shows that state expenditures on interest and pensions have overtaken the share of GDP spent by the States on economic services and capital expenditures and is rapidly approaching the share of GDP that States are now spending on social services. Although capital expenditures as a share of GDP are beginning to recover to the levels of the early 1990s, they are still substantially lower as a share of GDP than in the early 1980s. The share of GDP spent on economic services has declined sharply as well. Expenditures on the operation and maintenance of capital assets used in each of these sectors have declined, while explicit and implicit subsidies to irrigation, power, and transport have increased.

Table 1 shows the aggregate trends in state deficits, including the steady but persistent revenue deficits in the early to mid-1990s and the sharp deterioration in revenue deficits beginning in 1998-99. The most persistent deterioration is observed in the ratio of revenue deficit to fiscal deficit, which indicates the extent to which borrowed funds are used to finance current expenditures. In 1993-94, this ratio was about 19 per cent. It has increased steadily to approximately 58 per cent by 2002-03. Finally, we see the accumulation of state debt, which was approximately 22 percent of GDP in 1993-94, and, as of 2002-03, it stands at 31.15 percent of GDP.

Section II. An Evaluation of India’s Intergovernmental Fiscal Transfer System

Generally speaking, intergovernmental fiscal transfers are used to correct for vertical and horizontal imbalances, inter-jurisdictional spillovers, and promote national objectives. Most federal countries, the U.S. appears to be the lone exception, use equalization grants to address horizontal fiscal disparities among jurisdictions. All countries, the U.S. included, use special purpose grants of one type or another to promote national priorities and address inter-jurisdictional spillovers. Equalization grants, special purpose transfers, and often different forms of revenue sharing in themselves a type of transfer, are used to help reduce vertical imbalances or the mismatch between expenditure responsibilities and own sources of revenues for sub-national governments.

However, the only fail proof way to address vertical imbalances is to provide sub-national governments with an adequate level of revenue autonomy. While a system of transfers is needed for many good reasons, it can easily be misused, and they should not be considered as a substitute for a healthy degree of tax autonomy, and this seems to be case of the states of India. The large vertical imbalance of the states arises from the fact that the central government has a greater taxing power while states have been entrusted with larger responsibilities.

In India, the high transfer dependency of the States has weakened accountability and fiscal discipline. Table 2 shows how transfers from the central government represent a significant part of state finances. Shared taxes and grants from the Center to the States represent over 4 per cent of GDP. We can see from the table that the share of transfers in state total revenues is nearly 38 percent which is about the same since the 1990's. The share of transfers in state total expenditures represents about 31 percent, which is a decrease from the high 30's in the 1990's. Certainly, this decline in the share of transfers in state expenditures is attributable to state expenditures increasing at a much faster rate than state revenues. The Center also transfers close to 1 per cent of GDP in the form of loans to the states. These resources constitute over one-third of the aggregate fiscal resources available to the states.

At any rate, in India, the high transfer dependency is not so much an issue compared to the complexity and lack of transparency and coordination of the transfer system. A notable feature is the multiplicity of transfer channels from the Center to the States. First, there is a constitutional mechanism to devolve tax shares and give grants.[1] Second, the Planning Commission gives grants and loans for implementing development plans. Finally, various ministries give grants to their counterparts in the States for specific projects which are either wholly funded by the Center (central sector projects) or requiring the states to share a proportion of the cost (centrally sponsored schemes) (Rao and Singh, 1998).

Additionally, there is a lack of coordination among the three current institutions in charge of implementing transfers. The development grants implemented by the Planning Commission create future non-plan expenditure liabilities for the states (i.e., debt service liabilities, infrastructure maintenance costs, and personnel costs). It is implicit in the gap filling of the grants-in-aid (GIA) approach that larger plan outlays financed by larger borrowing create larger state liabilities, which, in turn, generate larger claims for additional fiscal transfer from the Finance Commissions. Furthermore, the Planning Commission often receives pressure from the Center and the states to accept that the states will be able to generate additional resources. Based on such arguments, the Planning Commission then authorizes the states to borrow additional amounts (Rao and Singh, 1998). Thus, there is a cycle of distorting incentives due to the fact that the decision process is fragmented, without any single institution being responsible for looking at the system of transfers as a whole.

Additionally, the Center has not fully exercised hierarchical control over state borrowing. The states have been able to avert the Center's constitutional debt controls through off-budget borrowings and guarantees. Market borrowings of the states do not reflect creditworthiness, which contribute to the lack of fiscal discipline among the states.

We now turn to evaluate central transfers according to the institutions in charge of intergovernmental transfers from the Center to the states:

a. The Finance Commission Transfers

A bulk of the central transfers to the States consists of general revenue sharing of proceeds of certain centrally levied taxes. The horizontal distribution is decided by the Finance Commission. In addition, the Finance Commission provides for grants-in-aid which are popularly known as "gap-filling" transfers as they are designed to cover for the deficit between projected expenditures and revenues after tax devolution with grants (Rao and Singh, 1998).

The transfer methodology adopted by the Finance Commissions has numerous weaknesses. First, the formula used for tax devolution lacks a clear purpose. For instance, the Eleventh Finance Commission (EFC) (2000-2005) mixed variables pertaining to fiscal capacity and expenditure needs, but it did not differentiate in a transparent way between these two fundamental means of equalization. The criteria of population, land area, and infrastructure index measure expenditure needs. But there is more to the measurement of expenditure need that is not covered by these indices, in particular the poverty rate, the unemployment rate, age structure, and the like. The only criterion for fiscal capacity, although with a weight of 62.5 per cent, is income disparity. A more direct method to measure fiscal capacity would be the size of tax bases and their potential yield, and the Twelfth Finance Commission (TFC) is actually moving in this direction.

Additionally, the EFC formula is pursuing more than an equalization objective because tax effort and fiscal discipline are in the formula. While these are worthwhile objectives, it is far from clear what they are pursuing within this framwork. The states also are unlikely to respond to these incentives due to their small weights in the formula. In many ways, the Finance Commission formula is not part of an equalization grant system but rather part of general or unconditional funding, which has equalization grant features. The TFC has tried to bring in the equalization principle for certain specific grants for education and health on the expenditure side. Although equalization should be pursued mostly, if not exclusively, by the equalization grant system in order to free up other grant instruments to pursue other objectives, this is a temporary positive move given the present need for more equalization in the system.

b. The Planning Commission Transfers

The Planning Commission (PC) in India is charged with the responsibility of enhancing productive public investments in the country by working out plan investments for each sector of the economy and each state based on the estimated resource availability.[2] States work out their respective annual plans for each year and then the Planning Commission approves them. However, the plan transfers suffer from a number of shortcomings (Bahl et al, 2005).

First, under pressure from the Center and States, it promotes increasing public investments even though they may be fiscally unsustainable. As a result, the PC pitches for higher 'Gross Budgetary Support' for plan, irrespective of the level of national or state indebtedness. The inability of the states to rein in revenue expenditure and an increasingly higher proportion of revenue expenditure component of their plans has contributed to the states running very high and persistent revenue deficits. This is aggravated by the selection of plan schemes for states by the Planning Commission. Increasingly, most of the schemes financed from the central assistance recommended by the Planning Commission are revenue expenditure schemes. A stage has come where most of the borrowings undertaken by the states for plan are going for funding the non-plan or revenue component of the plan schemes.

Second, the central assistance released through the Planning Commission is also in loan and grant form. The Gadgil formula 70-30 (10-90 in the case of special category states) loan-grant transfers create incentives for the states to assume debt in order to get the grant even though they otherwise may not have borrowed the funds because of their very high debt levels and for other reasons. The Planning Commission’s development projects create budgetary obligations on the states (debt service, maintenance and operation costs, and personnel costs) that are many times now shifted to the non-plan side as the states in their misconceived interest continue to treat these as plan expenditure, which prevents the Finance Commission from taking these into account when they make their recommendations.

The present process tends to generate low rates of return on investments because there is a bias in favor of taking up new projects while projects that are underway are not fully funded and allowed to languish and remain unfinished for long periods of time. The longer periods for completion lower the rate of return on projects. Besides, the states are under funding maintenance and the current process does not provide any incentives to prevent this, which results in the faster deterioration in public infrastructure, and further lowering the rate of return.

Third, the Gadgil formula, just as the Finance Commission formula, is a mixture of expenditure need and fiscal capacity elements, which are again mixed with other objectives (i.e. tax effort, fiscal management, national objectives, and special problems). The Finance Commission’s transfers are much more equalising than the Planning Commission’s because the criterion of per capita income disparities is much more equalising than the population criterion (Rao, 2000). The Finance Commission’s formula weights income disparities much more heavily than the Planning Commission’s formula (62.5 versus 25 per cent, respectively); and the Planning Commission weights population more heavily than the Finance

Commission (60 versus 10 per cent, respectively). Furthermore, the Gadgil formula is applied for allocation of only what is known as normal central assistance (NCA). There are several schematic allocations going through the state plan channel, which has different bases for resource allocation.

c. Other Transfers – Centrally Sponsored Transfers

Assistance provided to the states through central sector and centrally sponsored schemes (CSSs) are an important source of revenue for the States of India, and in some respects they are the most controversial form of transfers due mainly to its arbitrariness and discretion. They are justified on the same bases as conditional grants are in other countries: addressing externalities/spillovers, pursuing national objectives, and so on, but it is generally recognized that there are too many schemes in India (Rao and Singh, 1998; Rao, 2000). In other countries, the problems associated with the proliferation of conditional grants generally has led to calls for (or effective) simplification and consolidation into a much smaller number of block grants.

In India, in contrast, the trend has been in the opposite direction with a continued growth in the number of schemes. Additionally, these schemes provide a backdoor for the federal government to micro-manage decisions that are ostensibly the responsibility of the states. Thus, CSSs burden the administrative capacity of the states and distort state decision-making and priorities. Furthermore, these schemes blur the lines of responsibility, particularly in the minds of voters.

d. The Problem of Soft Budget Constraint

Soft budget constrains typically arise when there is a high vertical gap, low sub-national revenue autonomy, high sub-national borrowing autonomy, and a history of debt forgiveness by the central government. In India, soft budget constraint has been institutionalized by the Center providing autonomous borrowing through plan loans, lending by the Center to the states, lending by the GoI owned institutions to the states without insistence on debt servicing capacity, ways and means advances from the Reserve Bank of India and MoF and the like. Neither the Center, nor the states, passed any law placing limits on their borrowing as envisaged in the Constitution of India. GoI has been providing substantial loan funding knowing fully well that the states are using the same for funding their revenue deficits. GoI in 2003 decided to adopt a fiscal responsibility law. Some states have also done so. Now, the TFC has recommended a fiscal responsibility law that places statutory limits on both revenue deficits and fiscal deficits. The financing framework of the states now needs to be brought within a regime of hard budget constraints.

The no bailout policy lacks credibility. In the past, the central government has rescheduled state debt and granted waivers of interest and principle, usually on the basis of recommendations of the Finance Commissions. The TFC has again recommended major debt-rescheduling with a lower rate of interest and a debt-waiver scheme. However, this has been linked to states adopting fiscal responsibility legislation and also to eliminating revenue deficits over a five year period. Nevertheless, such waivers may create expectations that the Center will bailout the states in the event of a future fiscal crisis. In which case, the states lack incentives to behave in a fiscally prudent manner. Many states also use off-budget borrowings and accumulation of arrears. Various orders have been issued by the GoI and the Reserve Bank of India (RBI), which would, if implemented, bring off-budget borrowing to an end.

Section IV. Options and Recommendations for Reform

The challenges facing India's intergovernmental fiscal system are wide and deep. Many of the key problems with the current system have their roots in the design of the constitution and legal system. These problems will be difficult but necessary to address. Other problems can be addressed through fine tuning of current institutions and processes. While the intergovernmental fiscal system in India would require reforms in other dimensions (i.e., revenue assignments, expenditure assignments, etc), we concentrate on evaluating options for reforming the intergovernmental fiscal transfer system. Although the TFC has made recommendations to correct some of the issues identified in this paper, we go further and provide additional options and recommendations.

Lack of adequate equalization.

Option 1: The objective of equalization could be exclusively pursued by an equalization grant system, which would distribute a pool of equalization funds via a formula based on the difference between expenditure needs and fiscal capacity of the states. This equalization grant system, should be designed, reviewed, and recommended by Finance Commissions every five years and implemented by the MoF. The formula used for the distribution of the equalization funds should capture the gap between estimated expenditure needs and fiscal capacity. Those states with a negative fiscal gap would not receive equalization grants, and the available funds would be distributed to each state with a positive fiscal gap in proportion; for example, to that state's share in the total sum of positive fiscal gaps. Other options are available for the final distribution of available funds, for example, by bringing up the worse off states to minimum desired disparity level. Expenditure needs could be based either on a weighted index of proxies for needs including population, poverty, and population profiles (school age and the elderly), and so on. Alternatively, they could be based on a set of financial per capita norms for the main expenditure responsibilities of the states. The fiscal capacity measure could be based on a representative revenue system methodology that captures the revenue potential of the state from the taxes assigned to them and their respective tax bases.

Recommendation 1: Equalization should be exclusively pursued by an improved and explicitly dedicated equalization grant system by merging the present tax share, Finance Commission's grants, and Planning Commission's NCA. The equalization grant will be funded by a stable formula as a share of dedicated central government revenues. The measurement of expenditure needs would be based on a weighted index of need proxies, and fiscal capacity would be measured by a modified representative revenue system that takes into account the revenue potential of the taxes assigned to the states. The Finance Commission should be entrusted with this job, and the MoF would be responsible for implementation. It may be necessary to make the Finance Commission a regular body in order to implement this recommendation.

Centrally Sponsored Schemes.

Option 1: A simplified, rationalized, and streamlined (very few in numbers) set of block grants could be established to replace the existing central schemes. As such, these conditional grants would be distributed as specific purpose grants, with very few rules and mandates, by the Center's line ministries. These would be very different from the current scheme-based programs in that they would be fully administered by the recipient sub-national government, with some discretion as defined by the specific nature of the transfer. These programs would be restricted to support those functions where increased state and local government spending are viewed as being in the national interest (i.e., improved fiscal management, tax administration, and improved social service delivery).

Recommendation 2: The existing CSSs should be rationalized and simplified into a small number of specific purpose conditional grants. The Center should indicate the broad mandate and objective of these grants, rather than issuing detailed guidelines which micro-manages state affairs and uses a one size fits all approach among the states. The states should be free to design their programs and projects with the grant consistent with the objectives of the grant. The Center should focus on evaluating the efficacy of these state programs and projects as well as the sufficiency and timeliness of funding.

Planning Commission's Loan Grants Create Distorting Incentives.

Recommendation 3: GoI should establish conditional matching grants for capital infrastructure purposes, after assessing the viability gap by way of grants, (i.e. without any borrowing component). These grants would be distributed to the states according to a formula based on population, land area, and an index of infrastructure deprivation.

Coordination between the Finance and Planning Commissions.

Option 1: The intergovernmental transfer functions of the Finance Commission and the Planning Commission could be merged into a single autonomous body.

Option 2: In light of the economic and intergovernmental fiscal reforms underway in India, the role of the Planning Commission could be re-focused. More specifically, the distribution of block grants by the Planning Commission in the form of NCA could be transferred to the Finance Commission. Additional Central Assistance schemes, being very similar to the CSSs, could be integrated with the CSSs. The Planning Commission's resource allocation role could be limited to CSSs. The Planning Commission could concentrate on appraisal, evaluation, and monitoring of these programs.

Recommendation 4: The Planning Commission should be given a new set of responsibilities that is consistent with the economic and intergovernmental reforms underway in India. These new responsibilities should include appraisal, evaluation, and monitoring of the programs and schemes; evaluating the creditworthiness of the states; and reporting to the nation about the success or failure of the projects. The distribution of block grants by the Planning Commission in the form of NCA should be transferred to the Finance Commission.

Soft Budget Constraint.

Option 1: Either through the creation of a federal-state pact resulting in a federal budget code and/or the adoption of "Fiscal Responsibility Acts" by all states independently, borrowing practices should be brought under control by imposing the golden rule (state borrowing can only be used to finance capital investment spending) and ceilings of total debt and debt service payments as a percent of the revenue budget. Overseeing and enforcing these provisions may require personal liabilities and prosecution under federal laws of state government officials, as in Brazil. Monitoring compliance with these norms should be assigned to an autonomous body in order to insulate it from political influence, in contrast to the practice in Brazil. The Union Government must also assist in developing a mechanism for reporting these data in a timely manner and auditing the state accounts to insure the quality of the information provided by the states.

Option 2: The Center could impose strict control and limits on state borrowing using its authority under Article 293(3) and disband providing loans from Union sources. State borrowing could be based on creditworthiness rather than need or an artificial sense of no-default. The Center could take measures to eliminate any form of inter-budgetary payment arrears, and prohibit state governments from borrowing from public enterprises of any sort. The Center could require the states to maintain at arms length the operation of existing public enterprises. The Center could require the inclusion of all contingent liabilities as part of the published quasi-fiscal deficit. The failure to repay debt as scheduled should carry significant consequences.

Option 3: Borrowing sources could be streamlined and borrowing limits re- imposed. All borrowing from special sources (required holdings of state government bonds by commercial banks, borrowing from pension funds, and shares of rural small savings, etc.) are examples of financial repression and should be phased out in a pre-announced manner over a two or three year period. Over the longer term, there should be a plan to phase-out all Union Government lending to the states (including small savings) and substitution of (consensual) private market lending. Imposing market discipline on state borrowing should be a long-term goal of the GoI and needs to be fully coordinated with financial sector reforms.

Recommendation 5: States should be encouraged to adopt fiscal responsibility laws imposing a strict hard budget constraint. The Center should simultaneously use its authority under Article 293(3) to impose prudent borrowing control. Following recommendations of the TFC, loans from the Center should be discontinued. Gradually all borrowing from special sources should also be eliminated.

Option 4: Leave it to the states to adopt fiscal responsibility laws on their own, with the Center exercising control only on borrowings by states to enforce a hard budget constraint.

Recommendation 6: It is recommended that the GoI encourage the states to pass balanced budget laws and follow the golden rule for capital expenditures, by using the leverage and incentives provided by the TFC and by exercising its authority under Article 293 to impose borrowing ceilings. Fiscal responsibility laws should have procedures and penalties that discourage the practice of passing budgets with unrealistic forecasts of expenditures and revenues. This could include limiting pay increases to government employees based on affordability, as mandated in the Financial Emergency provisions of the Constitution of India.

Sub-National Government Debt Bailouts.

Option 1: The experiences of Brazil and Mexico with fiscal adjustment through debt-rescheduling and debt forgiveness, respectively, followed by a regulatory framework, and a credible no-bailout commitment may present a reasonable option for stabilizing the most fiscally distressed sub-national governments (Bahl et al, 2005). In India, this could be an option to stabilize budgets in the most indebted states, such as Rajasthan and West Bengal, in exchange for strict control, at least for a reasonable length of time. The TFC calls for rescheduling of existing central government debt of the states and debt waiver linked to states adopting fiscal responsibility laws and eliminating their revenue deficits by 2008-09.

Option 2: The GoI could immediately enforce a hard budget constraint.

Option 3: If a state becomes fiscally insolvent, which is a real possibility, the Center may not be able to hold to a no bailout policy. If so, it may be wise to have a clear set of policies regarding the circumstances under which debt forgiveness will be granted to a state.

Option 4: Capping the size of contingent liabilities assumed by state governments, and including all contingent liabilities as part of the published quasi-fiscal deficit.

Recommendation 7: Establish a clear set of policies regarding the circumstances under which debt forgiveness will be granted to a state in the case of fiscal insolvency. It may be advisable to bring a law under the financial emergency provision of the Constitution to define the conditions where a State may be declared to be in financial emergency and rules for its resolution, such as restructuring and privatizing state owned enterprises, eliminating subsidies, cutting down on salaries, and pension reforms.

Section V. Conclusion

The preceding analysis of the fiscal condition of the States of India reveals serious concerns about the intergovernmental fiscal system in India. Although issues on the intergovernmental fiscal system in India are wide (i.e. expenditure, revenue, transfers, borrowing, local governments), in this paper we exposed our concern with the intergovernmental fiscal central-state transfer system, which as many other authors have recognized, it lacks objectivity, transparency, simplicity, fairness, and most importantly it induces the states into perverse incentives and soft budget constraints.

Although designing an appropriate intergovernmental transfer system has been a challenge in most federations, and we cannot disregard India’s system’s achievement, there are some options that India could consider in order to move towards a more optimal design of its transfer system. While the option of merging the Finance and Planning Commissions into a single permanent unit has been highly controversial, it should be possible to re-focus the roles of the Finance and more importantly the Planning

Commission into a grant system with clear objectives and with the appropriate incentives for both the Center and the states. Equalization could be exclusively pursued by an improved and explicit equalization formula while CSSs could be rationalized and simplified into a small number of specific purpose conditional grants. As far as the concerns of soft budget constraints, states should be encouraged to adopt fiscal responsibility laws imposing a strict hard budget constraint (i.e. passing balanced budget laws and the golden rule for capital expenditures). The Center could simultaneously use its authority impose prudent borrowing control and establish a clear set of policies regarding the circumstances under which debt forgiveness will be granted to a state in the case of fiscal insolvency.

Although the Twelfth Finance Commission has addressed some of the issues related to the intergovernmental fiscal transfer system and soft budget constraint, there is still an urgent need to tackle other issues that create perverse incentives and soften budget constraints This emphasizes the need for the State and Union Governments of India to strengthen and accelerate the reform of India's intergovernmental system.

Endnotes

[1] States other than the eleven special category states (SCS) are referred to as the general category states (GCS). States of Uttar Pradesh, Madhya Pradesh, and Bihar are taken as undivided states for purposes of comparison for the entire period. T he constitutional mechanism for central transfers consists of devolving the shares of individual income tax (Article 270) and union excise duties (Article 272), and giving grants-in-aid to the states in need of assistance (Article 275). Tax devolution and grants are based on recommendations of a semi-judicial body, the Finance Commission, to be set up by the president of India every five years, under article 280.

[2] Estimated resource availability includes the balance from current revenue, contributions of public enterprises, additional resource mobilization, plan grants and loans, market borrowings and other miscellaneous capital receipts (Rao and Singh, 1998).

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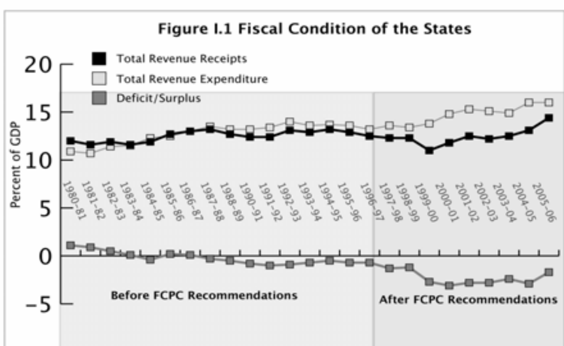

Figure I.1 Fiscal Condition of the States

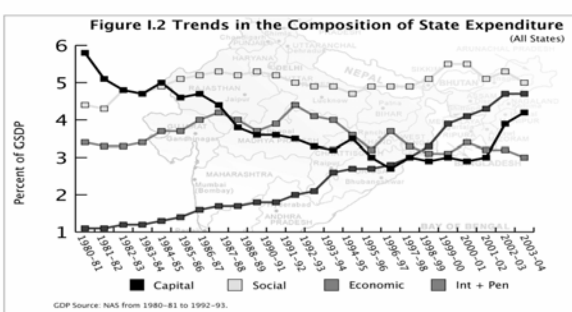

Figure I.2 Trends in the Composition of State Expenditure

Table 1:
Aggregate State Finances: Alternative Deficit Indicators
(per cent of GDP)

Year	Revenue Deficit	Fiscal Deficit	Primary Deficit	Revenue Deficit/ Fiscal Deficit	Debt/GDP
1993-94	0.45	2.35	0.52	19.05	21.79
1994-95	0.69	2.72	0.79	25.55	21.40
1995-96	0.73	2.59	0.76	28.06	21.00
1996-97	1.31	2.77	0.90	47.37	21.00
1997-98	1.23	2.94	0.93	42.01	21.73
1998-99	2.61	4.31	2.24	60.48	23.02
1999-00	2.82	4.64	2.34	60.87	25.20
2000-01	2.61	4.16	1.69	62.60	27.42
2001-02	2.68	4.09	1.41	65.49	29.37
2002-03	2.29	3.94	1.14	58.09	31.15
Averages:					
1993-96	0.62	2.55	0.69	24.22	21.79
[A]	2.53	4.07	1.41	62.06	31.15
2000-3	1.90	1.51	0.72	37.84	9.36
[B]					
[B]-[A]					

Source: RBI (2004).

Table 2.
Central Transfers to the States

Year	Transfers as a % of GDP	Transfers as a % of Central Tax Revenues	Transfers as a % of State Total Revenues	Transfers as a % of State Total Expenditures
1993-94	5.07	50.10	42.39	40.85
1994-95	4.41	42.77	39.13	36.84
1995-96	4.20	42.13	38.50	36.08
1996-97	4.23	47.96	39.50	35.16
1997-98	4.23	46.43	39.17	35.16
1998-99	3.61	38.57	38.78	29.07
1999-00	3.79	40.28	36.94	28.98
2000-01	4.22	46.17	38.22	30.92
2001-02	4.12	49.88	38.76	30.95
2002-03	4.02	45.32	37.33	30.80

Source: Author's calculations from Report of the Twelfth Finance Commission (2004).